



NATIONAL CONFERENCE *of* STATE LEGISLATURES

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TESTIMONY OF
SENATOR STEVEN RAUSCHENBERGER
ASSISTANT REPUBLICAN LEADER
ILLINOIS SENATE
PRESIDENT, NATIONAL CONFERENCE OF STATE LEGISLATURES

ON BEHALF OF THE
NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING
**STATE TAXATION OF INTERSTATE
TELECOMMUNICATIONS SERVICES**

BEFORE THE
**SUBCOMMITTEE ON ADMINISTRATIVE AND COMMERCIAL LAW
COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES**

JUNE 13, 2006

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Chairman Cannon, Ranking Member Watt and members of the Subcommittee on Commercial and Administrative Law, I appreciate the invitation to testify before you today on behalf of the National Conference of State Legislatures (NCSL). I am Steve Rauschenberger, Assistant Republican Leader of the Illinois Senate and President of NCSL. The National Conference of State Legislatures is the bi-partisan organization representing every state legislator from all fifty states and our nation's commonwealths, territories, possessions and the District of Columbia.

I am pleased to have the opportunity to speak to you about the current status of state and local taxation of telecommunications services and the need for government at all levels to address telecommunications tax reform. The elimination of boundaries, new technologies and increased convergence and competition in telecommunications makes it critical to simplify and reform state and local taxes to ensure a level playing field, to enhance economic development, and to avoid discrimination among telecommunications providers. Consumers' telecommunications choices must not be made on the basis of outdated tax regimes.



State and Local Taxation of Telecommunications – The Current Regime

For almost 100 years, until 1984, telephone service was a highly regulated industry in which consumers did not have a choice of a provider. If they wanted phone service, consumers had one choice, the monopoly provider in their service area and in most cases that provider was AT&T, the parent company of the Bell System. Phone companies were regulated by the state public service or utility commissions. These providers were subject to tax under statutes applicable to "public utilities" and such taxes in the form of gross receipts, franchise and other industry-specific taxes were passed on to consumers as part of the regulatory rate setting process.

The monopoly phone companies normally did not oppose tax increases by state and local governments. The tax increase was passed onto the consumer and the phone company did not have to worry about the consumer looking for a cheaper alternative provider as there was no competition. A state and local government could tax telecommunications at a rate higher than any other business with little or no outcry from unsuspecting constituents, "it was just that damn phone company raising rates again!!!"

In 1984, with the settlement of the antitrust suit brought by the United States against AT&T and Bell Laboratories, the age of telecommunications monopolies started to unravel. AT&T was divested of its local operating companies and faced competition for long distance service. However, local exchange business was still operated as a monopoly by the eight Baby Bells (of which, there will soon only be three.)

In the 1990's many states began efforts to deregulate local markets and open these markets to competition. In the Telecommunications Act of 1996, Congress further opened local markets by allowing the regional Bell companies to enter into long distance service when the local market was sufficiently competitive. In most states, the deregulation of the industry was not accompanied by corresponding elimination, simplification, or restructuring of taxes that have historically been levied on regulated companies.



The primary goal of the federal Telecommunications Act of 1996 was to open telecommunications markets to competition. Ten years later competition exists but not solely as a result of the 1996 Act or similar state efforts. Competition also has occurred as a result of increased consumer access to wireless and cable communications services and the ability of consumers to communicate over the Internet through Instant Messaging, e-Mail, and now Voice over Internet Protocol (VOIP).

Innovation and convergence of existing technologies are radically expanding telecommunications services, blurring distinction between telephone and Internet services; between cable, wireless and satellite; between long distance and local service; and between telephone and other forms of communications.

Many of these new technologies are capable of delivering telecommunications services but do not fit within the definitions of the traditional regulatory framework for telecommunications. As a result, similar services can be delivered via networks that are taxed differently, and for a growing number of technologies, these services are free of state and local taxation. This uneven governmental treatment, while not intentional, has led to competitive barriers, discouraged investment in infrastructure development by traditional providers, and impacted the roll out of advanced telecommunications services. Imposing these higher tax burdens on telecommunications services provided by some telecommunications providers, while imposing lower and even no tax burdens on similar services sold by non-traditional providers, places governments in the position of picking winners and losers in the marketplace.

One of the legacies of the former monopolistic structure is that state and local tax burdens on telecommunications companies and their customers are significantly above those imposed on most other types of industries and services. In its 2004 State Study and Report on Telecommunications Taxation, the Council on State Taxation (COST) found that the average rate of state and local taxes on taxes for telecommunications services was 14.17 percent, compared to only 6.12 percent for taxes on general business.



This discrepancy between taxes on telecommunications services and general business amounts to discriminatory taxation of telecommunications. State and local governments will sometime levy discriminatory taxes on products that society would like to discourage consumption for the general good. Most states and local governments levy such discriminatory taxes on the purchase of alcohol and tobacco. These taxes are usually referred to as “sin taxes.”

I believe we all can acknowledge that telecommunications and advanced technology is a vital component of this country’s economic growth and stability. Why then does government want to treat the use of telecommunications services as if it was harmful to the overall economic well being and welfare of society? No reasonable policymaker can continue to justify this discriminatory tax regime on communications services. State and local governments can no longer hide behind the smokescreen that transactional taxes on telecommunications services are on the provider. We can no longer hide from the fact that discriminatory taxation of telecommunications is a direct tax on our constituents.

Collection and Administration of Telecommunications Taxes

Another discriminatory throwback to the monopoly age of telecommunications is the collection and administration of telecommunications transactional taxes.

Telecommunications providers are subject to taxation in almost 14,000 jurisdictions and in 2004, according to the COST Report, filed almost 48,000 returns in many cases directly to these 14,000 jurisdictions. The administrative and collection burden forces telecommunications providers to incur substantial expenditures to satisfy compliance and systems requirements, resulting in higher costs of service for consumers without any corresponding benefit to state or local governments.



NCSL Telecommunications Tax Reform Principles

In 1999, the Executive Committee of the National Conference of State Legislatures established the Task Force on State and Local Taxation of Telecommunications and Electronic Commerce, which I had the pleasure to co-chair until last year, to review the current state and local taxation regimes on telecommunications and to formulate a set of principles for how state legislatures should address the simplification and modernization of taxes on telecommunications services. The Task Force also was instrumental in working with governors, tax administrators and the private sector in developing the Streamlined Sales and Use Tax Agreement.

The Task Force approved a set of principles for telecommunications tax reform that have been unanimously endorsed by the NCSL Executive Committee:

Tax Efficiency: State and local taxes and fees imposed on telecommunications services should be substantially simplified and modernized to minimize confusion and ease the burden of administration on taxpayers and governments.

Competitive Neutrality: State and local transaction taxes and fees imposed on telecommunications services should be applied uniformly and in a competitively neutral manner upon all providers of telecommunications and similar services, without regard to the historic classification or regulatory treatment of the entity.

Tax Equity: Under a uniform, competitively neutral system, industry-specific telecommunications taxes are no longer justified.

Tax Fairness: With the blurring of distinctions between various services and technologies, state and local governments must strive to set tax burdens on telecommunications services, property and providers that are no greater than those tax burdens imposed on other competitive services and the general business community.



Local Government Impacts: States need to include provisions to mitigate potential local government revenue impacts associated with telecommunications tax reform.

Economic Development: States need to simplify, reform and modernize state and local telecommunications tax systems to encourage economic development, reduce impediments to entry, and ensure access to advanced telecommunications infrastructure and services throughout the states.

State Sovereignty: NCSL will continue to oppose any federal action or oversight role which preempts the sovereign and Constitutional right of the states to determine their own tax policies in all areas, including telecommunications.

Transactional taxes and fees imposed on telecommunications services, including the collection and administration of those taxes and fees, should be simplified and modernized to minimize confusion, remove market distortion and eliminate discrimination regarding the taxability of telecommunications services. Let us not forget that these transactional taxes and fees as well as the cost of collection are not paid by the telecommunications provider but in almost all cases passed onto consumers, thus raising the costs of telecommunications services and quite possibly widening the so-called “digital divide.”

In addition, discriminatory taxes on telecommunications services have a more regressive impact on low income taxpayers. Obviously, the more services a consumer chooses from a telecommunications provider, the higher the taxes that consumer will have to pay. By maintaining the current discriminatory tax regime, government is increasing the price range for many communications services by an average 15 percent nationwide and thus placing them out of the financial reach of many low income taxpayers.



Telecommunications Tax Reform – Easier Said Than Done

Over the past few years, NCSL has made telecommunications tax reform a major priority for states to consider. We have spent much time educating state policymakers on the need to simplify and modernize taxes on telecommunications services as well as the benefits in doing so. While I would like to report that our efforts have met with great success, the fact that we are having this hearing today points to the slow progress that has been made.

One area where we have seen moderate success has been in the reduction of returns that are filed by telecommunications providers. The 2004 COST Report shows that the number of returns dropped from almost 67,000 in 2001 to almost 48,000 in 2004. This reduction of returns can be attributed to state legislative efforts in Florida, Ohio, Tennessee, Utah and Illinois. This reduction while noteworthy is still too high compared with the returns filed by general business, 7,500.

Unfortunately, progress in rate reform has even been slower. Only a handful of states have addressed rate reform to some degree in the last few years, the most recent being Kentucky, Missouri and Virginia.

Earlier this year, the Virginia General Assembly completed action on efforts that began in 2002 to reform telecommunications taxes. Prior to this action the average tax rate in Virginia on telecommunications services was 29.77 percent, which was 15 percent higher than the national average. The Virginia legislation, H.B. 568, sponsored by Delegate Sam Nixon, lowers the combined state and local rate to 5 percent and extends the tax to communications services previously not taxed such as satellite and VOIP. The Virginia legislation also reduces the number of returns by having the providers remit the funds collected to the state for distribution to local governments. NCSL is using the Virginia legislation and experience in enacting the reform as a model for other states to consider.



However, the slowness in progress is not simply due to a lack of desire on the part of policymakers to reform telecommunications taxes. As the sponsors of the Virginia legislation will tell you, “Telecom Tax Reform is Easier Said Than Done.” It took Virginia policymakers five years to enact reform. As we all know, tax reform of any kind does not happen in a vacuum. While there are many stakeholders who will benefit from tax reform, others, e.g. new providers of communications services and many local government officials, will work to defeat any legislative effort to reform tax rates. Another obstacle has been the lack of public arousal over discriminatory telecommunications taxes. This is partially due to the monopoly legacy, many consumers think it is still the phone company just raising rates again. I will briefly discuss the obstacles to tax reform.

New Provider Opposition

As I discussed, there are providers of communications services, who because of the medium used to deliver the service, may not be taxed at the same level as the more traditional landline, wireless and cable providers, if they are taxed at all. These new providers see their tax status as a competitive edge and will work to stop any effort in state legislatures that would increase or tax their service to achieve competitive neutrality. For example, the satellite industry was successful in 2005 in Virginia in bringing consideration of the telecommunications tax reform legislation to a halt. The satellite providers notified their customers that the General Assembly wanted to place a tax of 5 percent on their satellite television service. Obviously, satellite providers failed to mention to their customers that their phone bill, whether wireless or landline, could decrease as much as 24 percent by the enactment of the same legislation.

While some VOIP providers presently collect state and local taxes on telecommunications, primarily those operated by a traditional carrier, pure-play VOIP providers, e.g. Vonage, only collect state and local taxes for the state in which they are located. If you have VOIP service through Vonage, and you are not a resident of New Jersey, your monthly charge is free of state and local taxes. If state legislatures are to



achieve competitive neutrality in taxing phone service, states will need to include such communications services as VOIP in the tax reform mix.

Local Government Role

Political subdivisions of the state, local governments and other special districts, have been given the authority to levy taxes and fees on telecommunications services either by state laws or state constitutions. In many cases the local governments managed the rights of way in which the phone companies provided service to consumers. Most states gave the local governments the ability to place a fee or tax on these services as a way to recoup any cost for the use of the rights of way. Overtime, especially during the days of monopoly providers, these fees increased often having nothing to do with the actual cost of using the right of way and became more a tax on the gross receipts of the phone company. The phone company did not complain, it was passed on to the consumer. The same story with regard to discriminatory property tax.

As states move to review the taxation of telecommunications services, we have faced strong opposition from many of our local governments. For at least the last 100 years, local governments have been able to tax telephone service at rates higher than states allow them to tax general business services and local governments receive the money directly from the provider unlike general business taxes which are normally (except for Alabama, Arizona, Colorado and Louisiana) remitted to the state for distribution to local governments. While I can understand local officials concerns about possible revenue loss as a result of telecommunications tax reform, these hidden tax increases on unsuspecting consumers can no longer be justified or allowed.

In 2005, the Missouri General Assembly approved a major reform of local government taxation of telecommunications, which modernized terms and definitions so as to have a broad range of services included and reduced the overall rate of taxation. The legislation also brought to an end some multi-million dollar law suits that local governments had



filed against wireless providers for not collecting a tax that they, wireless providers, contended did not apply to them based upon the definition of phone service in state law. Even though the new legislation assured that local governments would maintain the level revenues received under the old system, many of the major cities in Missouri have challenged the constitutionality of the legislation and the legislatures authority to take such action. The Missouri Supreme Court heard oral arguments in April and a decision is expected shortly. NCSL filed an amicus brief on behalf of the Missouri General Assembly and supported its authority under the Missouri State Constitution to change the taxing authority of local subdivisions of the state as they will.

To be fair, I should point out that in Virginia, local governments were more willing to join negotiations and this certainly helped with the enactment of the Virginia legislation.

Last year, NCSL participated in process moderated by the National Governors Association which included our members, governors, local officials and representatives of the telecommunications industry. While there was agreement on some broad principles of reform, getting agreement on precise solutions to achieve those principles was elusive. I believe there was considerable consensus between state government representatives and industry representatives.

Provider and Consumer Role

As I stated earlier, tax reform of any kind usually does not occur in a vacuum. Telecommunications tax reform will likely be controversial in any state for some of the reasons stated above. State legislators need to hear not only from providers that there is a problem, how discriminatory taxation is a competitive barrier, but also from consumers, from the legislators' constituents. I have heard from numerous legislators that while they appreciate NCSL's advocacy on telecommunications tax reform, they have not heard much from their constituents about how much they are paying in taxes on telecommunications services.



NCSL has urged the providers and their associations to do a better job in educating the public about discriminatory telecommunications taxation. State legislators anticipate that should they consider tax reform legislation they will see publicity campaigns blaming them for wanting to reduce the taxes of wealthy telecommunications companies and thus forcing cutbacks in such areas as first-responders and teachers. The industry needs to support state legislative efforts with vigorous campaigns educating the consumer, the constituent, that these taxes are being paid by them not the companies and any reform will mean more money in the consumers' pockets.

I want to acknowledge the work of "MyWireless.org" which serves to educate consumers about the impact of state and local taxes on wireless services. This kind of education of consumers is vital. Like members of Congress, few state legislators will take the political risk of taking on powerful stakeholders in opposition to telecommunications tax reform if there is little or no support for such efforts from our constituents.

Federal Role in Telecommunications Tax Reform

While NCSL believes that telecommunications tax reform is primarily in the purview of elected state policymakers, we also acknowledge that with the end of the monopolistic era, telecommunications services and advanced technology networks do not respect state borders. What role should Congress and the Administration play in assisting states to achieve telecommunications tax reform?

Federal Role in State Telecommunications Tax Rate Reform

As I mentioned earlier, I am pleased to participate in this oversight hearing on the current status of telecommunications taxation. It is hearings such as this, that allows NCSL to raise the alarm with our members that we need to address this issue or face possible federal involvement, whether right or wrong, in an area that has traditionally been under the purview of state authority. We certainly would prefer to be able to work out



telecommunications tax reform legislation on a state by state basis with all the stakeholders rather than be forced to address these issues under a federal mandate that might not provide much flexibility to state legislatures to address issues that may be peculiar to a certain state or region.

While federal legislation has not been introduced or even appears in the title of this hearing, I think it is fair to assume that most of us have heard about proposals being considered that would require states to reform telecommunications taxation. Let me say for the record that NCSL could not support a blanket preemption of state taxing sovereignty with regard to telecommunications services. However, we are willing to work closely with the members and staff of this Subcommittee, our colleagues at the National Governors Association, and the representatives of the telecommunications providers on legislation that would encourage states to enact telecommunications tax reform legislation.

Should federal legislation be introduced to encourage states to address tax reform, NCSL would urge the members of this Subcommittee to include provisions that would allow states the ability to treat all providers of communications services in a competitively neutral manner. If we are to avoid having government pick winners or losers in the communications marketplace, Congress should remove any previous prohibitions on states from taxing certain telecommunications services as well as allowing states to include such services as VOIP. If VOIP services continue to be generally free of state and local taxation, many landline, wireless and cable providers will continue to have a competitive disadvantage.

Any federal legislation should also include a sufficient timeframe for states to address tax reform. States legislatures need at least two full sessions to consider tax reform legislation and I would respectfully remind this Subcommittee that there are still six state legislatures that only meet once every two years. As any tax reform likely will have revenue impact, it would be helpful both for states and local governments to have sufficient time to include this impact in their budget planning.



Finally, legislation that provided some kind of incentives, particularly geared to mitigating possible revenue loss also would be helpful. One possibility would be for Congress to consider and move the Sales Tax Fairness and Simplification Act.

Sales Tax Fairness and Simplification Act

The Sales Tax Fairness and Simplification Act would require states to apply the uniformity and simplifications of the Streamlined Sales and Use Tax Agreement to the collection and administration of all transactional taxes on telecommunications services, including rights of way fees and franchise fees, as a condition that a state would have to meet before the state could enjoy the authority to require remote sale tax collection. This provision in the federal legislation has the support of both NCSL and the National Governors Association.

The Sales Tax Fairness and Simplification Act of 2006, S. 2152, has been introduced by Senator Mike Enzi of Wyoming. I realize a companion bill has not been introduced in the House of Representatives as of yet, and we are hopeful that a bill will be introduced shortly. I want to acknowledge Congressman William Delahunt of Massachusetts, a member of this Subcommittee, for his previous sponsorship and support of this legislation and we look forward to having him as a sponsor in this Congress.

Congress has the opportunity to move a major part of the telecommunications tax reform agenda, collection and administration simplification, and in doing so, reducing the number of returns from the current 47,000 to a few hundred a year. This would substantially reduce provider compliance costs by the hundreds of millions of dollars each year and as a result reduce the cost of service to consumers. For this reason, most of the major telecommunications providers have endorsed the Sales Tax Fairness and Simplification Act.



One of the issues hindering telecommunications tax reform in the states, is the potential loss of revenue primarily at the local government level. A recent study has shown that revenue from telecommunications taxes is becoming the second largest revenue source for local governments after the property tax. If state legislatures try to reduce telecommunications taxes to the level of general business tax, we have two options, reduce rates on telecom providers by reducing revenues over the opposition of local government officials or reduce rates on telecom providers and raise rates on general business to offset the revenue loss. As you can guess, every industry that is not a telecommunications provider will rise up to oppose this alternative.

States do not have large surpluses of funds available to mitigate revenue loss from telecommunications tax reform, even over the short term. However, states could use some of the new revenues from presently uncollected sales taxes on remote transactions to help mitigate revenue loss from telecommunications tax reform. Congress in passing the Sales Tax Fairness and Simplification Act could give states the revenue they would need to mitigate revenue loss from reducing the discriminatory rates on telecommunications services.

The COPE Act

Congress has an excellent opportunity in H.R. 5252, the “Communications Opportunity, Promotion and Enhancement Act of 2006” or the COPE Act, to take an additional step toward telecommunications tax reform. While the legislation establishes a national franchise for video providers, many of whom are telecommunications providers, the legislation still requires the payment of franchise fees directly to the franchise authority. This means that video providers could still be sending returns to over 33,000 franchise authorities. Congress and the communications industry have the opportunity to take a step toward reform by reducing the returns to one per state, as the Sales Tax Fairness and Simplification Act would do. If Congress and the providers are serious about communications tax reform then collection and administration reform of franchise fees and taxes on video services must be included in any legislation to establish nationwide



video franchising. Congress can reduce the number of returns from 33,000 to 50, one per state.

Conclusion

The Mobile Telecommunications Sourcing Act of 2000 (MTSA) is a good example of Congress, state and local governments and industry working together on legislation that preserved state taxing authority while ensuring a uniform and simplified system for the collection of the taxes. We worked together in 2000 on a national tax regime for wireless services and I believe we can work together again.

A number of members of this Subcommittee have served in the state legislature, and I am sure if you think back to those golden days, you will recall how nervous we get whenever Congress begins to look at state laws, especially our ability to levy taxes. However, sometimes this can be a good thing. I believe this hearing and the threat of federal legislation will help NCSL to re-focus state efforts to address telecommunications tax reform for the 2007 legislative sessions. I would encourage this Subcommittee to continue these oversight hearings and should you introduce legislation, I would respectfully request that you work with NCSL and our counterparts in the National Governors Association.

Thank you for this opportunity.

